Sector Rankings For ETFs & Mutual Funds

an article from blog.newconstructs.com

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We are offering this report for free to start off the 3Q14 Best and Worst ETFs and Mutual Funds *series. However, most of our reports, which include detailed analysis of all 10 sectors and 12 fund styles, will be available to subscribers only. We will be updating all the sector reports and all the style reports from last quarter. For a limited time, you can get access to all our reports for just $9.99/month.*

At the beginning of the third quarter of 2014, only the Consumer Staples sector earns an Attractive-or-better rating. My sector ratings are based on the aggregation of my fund ratings for every ETF and mutual fund in each sector.

Investors looking for sector funds that hold quality stocks should look no further than the Consumer Staples and Information Technology sector. These sectors house multiple Attractive-or-better rated funds. Figures 6 and 7 provide details. The primary driver behind an Attractive fund rating is good portfolio management, or good stock picking, with low total annual costs.

Note that the Attractive-or-better Predictive ratings do not always correlate with Attractive-or-better total annual costs. This fact underscores that (1) low fees can dupe investors and (2) investors should invest only in funds with good stocks and low fees.

See Figures 4 through 13 for a detailed breakdown of ratings distributions by sector. See my free ETF & mutual fund screener for rankings, ratings and free reports on 7000+ mutual funds and 400+ ETFs. My fund rating methodology is detailed here.

All of my reports on the best & worst ETFs and mutual funds in every sector and investment style are available here.

Figure 1: Ratings For All Sectors

Sector	Predictive Rating	Portfolio Management Rating	Total Annual Costs Rating
Utilities	Very Dangerous	Very Dangerous	Neutral
Financials	Dangerous	Dangerous	Attractive
Energy	Dangerous	Dangerous	Neutral
Materials	Dangerous	Dangerous	Attractive
Health Care	Neutral	Dangerous	Attractive
Telecom	Neutral	Dangerous	Attractive
Cons Disc	Neutral	Dangerous	Attractive
Info Tech	Neutral	Neutral	Neutral
Industrials	Neutral	Neutral	Attractive
Cons Staples	Very Attractive	Neutral	Very Attractive

Source: New Constructs, LLC and company filings

To earn an Attractive-or-better Predictive Rating, an ETF or mutual fund must have high-quality holdings and low costs. Only the top 30% of all ETFs and mutual funds earn our Attractive or better ratings.

State Street SPDR Consumer Staples Select Sector Fund ETF (XLP) is my top rated Consumer Staples fund. It gets my Very Attractive rating by allocating over 30% of its value to Attractive-or-better-rated stocks.

Wal-Mart Stores, Inc. (WMT) is one of my favorite stocks held by XLP. Due to the earnings disappointment in 2Q14, investors are presented with a great opportunity. Over the past decade, WMT has grown after-tax profit (NOPAT) by 8% compounded annually while maintaining a remarkably consistent return on invested capital (ROIC) of ~12%. Over the same time period, WMT has grown its economic earnings by 11% compounded annually. However, investors failed to remember the track record of WMT and upon the 2Q earnings announcement, the stock sold off 6%. At its current valuation of ~$76/share, WMT has a price to economic book value (PEBV) of 0.9. This ratio implies the market expects WMT's NOPAT to permanently decline by 10%, which seems unlikely. One lackluster quarter is little more than a blip on the radar for WMT. WMT is a great buy on the dip opportunity at the moment.

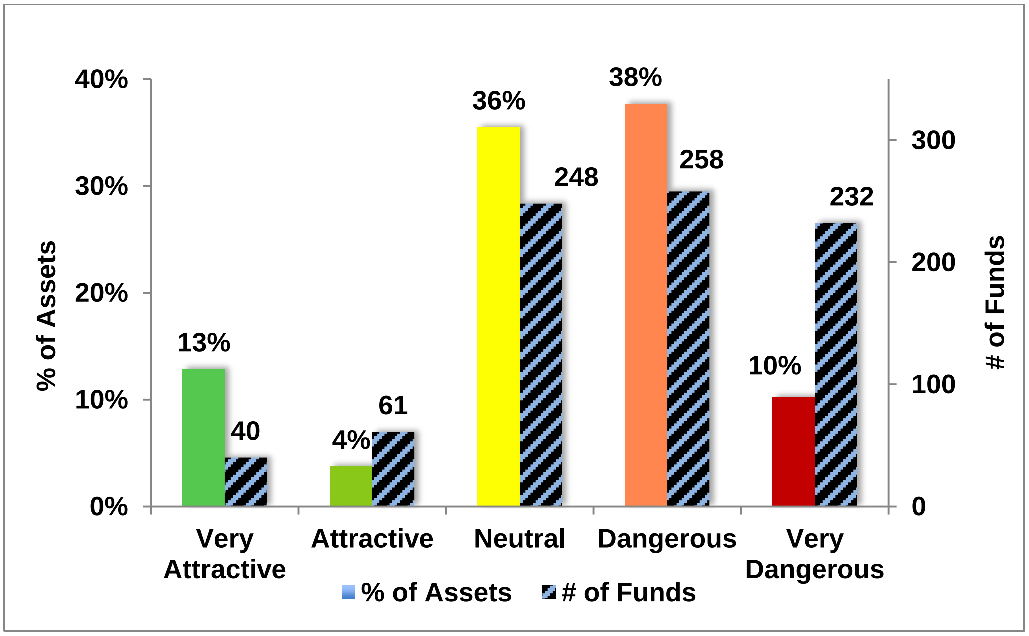
Oppenheimer Real Estate Fund (OREAX) is my worst Financials fund. It gets my Very Dangerous rating by allocating over 80% of its value to Dangerous-or-worse-rated stocks, and to make matters worse, charges investors annual costs of 4.23%.

Boston Properties, Inc. (BXP) is one of my least favorite stocks held by OREAX and gets my Very Dangerous rating. It also makes the Most Dangerous Stocks list for July. Over the past decade, BXP has only managed to grow NOPAT by 2% compounded annually. Over this same time period, BXP's return on invested capital ROIC has fallen to 6%, down from 9% in 2003. To make matters worse, the company has only generated positive economic earnings in four of the last 10 years, three of which occurred during the real estate boom of 2005-2007.

Despite these struggles, BXP is still valued as a high growth company. The current price of ~$117/share implies that the market expects BXP to grow NOPAT by 10% compounded annually for the next 26 years. While the real estate market may be on its way to recovery, I feel it is quite optimistic to think BXP could meet these expectations given its minimal growth over the past decade. Low growth, declining profitability, and overzealous market expectations make BXP a stock investors should avoid.

Figure 2 shows the distribution of our Predictive Ratings for all sector ETFs and mutual funds.

Figure 2: Distribution of ETFs & Mutual Funds (Assets and Count) by Predictive Rating



Source: New Constructs, LLC and company filings

Figure 3 offers additional details on the quality of the sector funds. Note that the average Total Annual Cost of Very Dangerous funds is almost 9 times that of Attractive funds.

Figure 3: Predictive Rating Distribution Stats

	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous
# of ETFs & Funds	40	61	248	258	232
% of ETFs & Funds	4.77%	7.27%	29.56%	30.75%	27.65%
% of TNA	12.86%	3.74%	35.50%	37.70%	10.20%
Avg TAC	0.30%	0.80%	0.71%	0.81%	2.61%

* Avg TAC = Weighted Average Total Annual Costs

Source: New Constructs, LLC and company filings

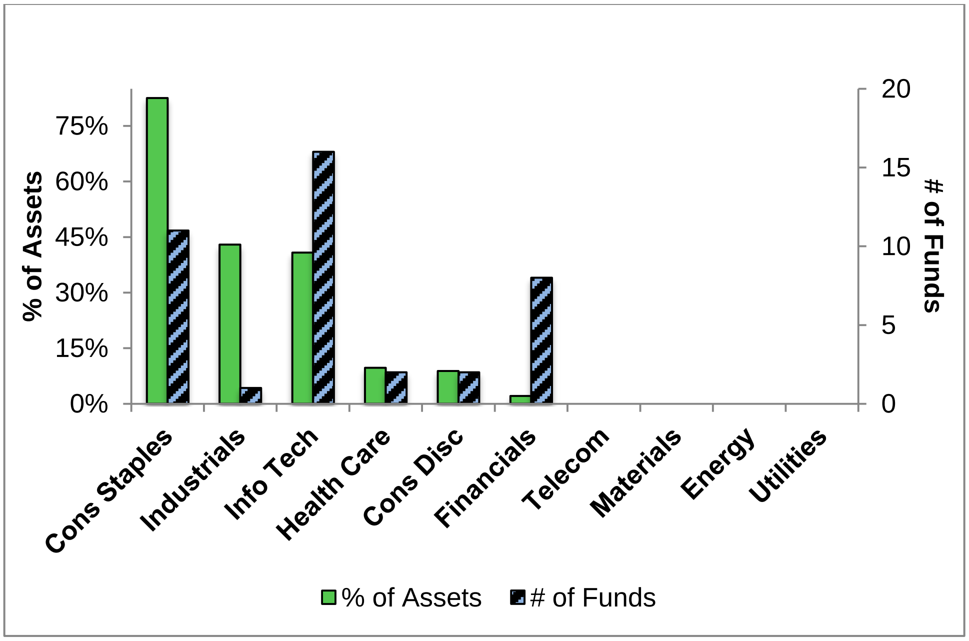
This table shows that only the best of the best funds get our Very Attractive Rating: they must hold good stocks AND have low costs. Investors deserve to have the best of both and we are here to give it to them.

Ratings by Sector

Figure 4 presents a mapping of Very Attractive funds by sector. The chart shows the number of Very Attractive funds in each sector and the percentage of assets in each sector allocated to funds that are rated Very Attractive.

As can be seen, six sectors contain funds that receive my Very Attractive rating. Being my overall top rated sector, it should be no surpise that the Consumer Staples sector allocates over 83% of assets to Very Attractive funds.

Figure 4: Very Attractive ETFs & Mutual Funds by Sector



Source: New Constructs, LLC and company filings

Figure 5 presents the data charted in Figure 4.

Figure 5: Very Attractive ETFs & Mutual Funds by Sector

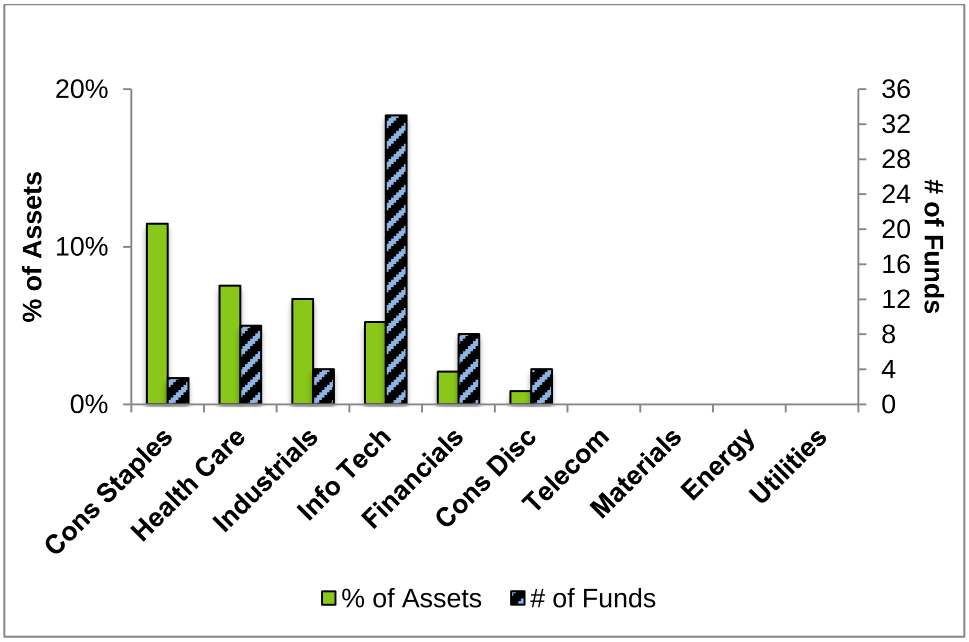
Sector	% of Sector Assets	# of Very Attractive Funds	% of Very Attractive Funds in Sector
Cons Staples	83%	11	58%
Industrials	43%	1	3%
Info Tech	41%	16	10%
Health Care	10%	2	2%
Cons Disc	9%	2	5%
Financials	2%	8	3%
Telecom	0%	0	0%
Energy	0%	0	0%
Utilities	0%	0	0%
Materials	0%	0	0%

Source: New Constructs, LLC and company filings

Figure 6 presents a mapping of Attractive funds by sector. The chart shows the number of Attractive funds in each sector and the percentage of assets allocated to Attractive-rated funds in each sector.

Note that the Information Technology sector contains 33 funds that receive my Attractive rating, the most of any sector. However, investors in this sector have only allocated 5% of assets to these Attractive funds.

Figure 6: Attractive ETFs & Mutual Funds by Sector



Source: New Constructs, LLC and company filings

Figure 7 presents the data charted in Figure 6.

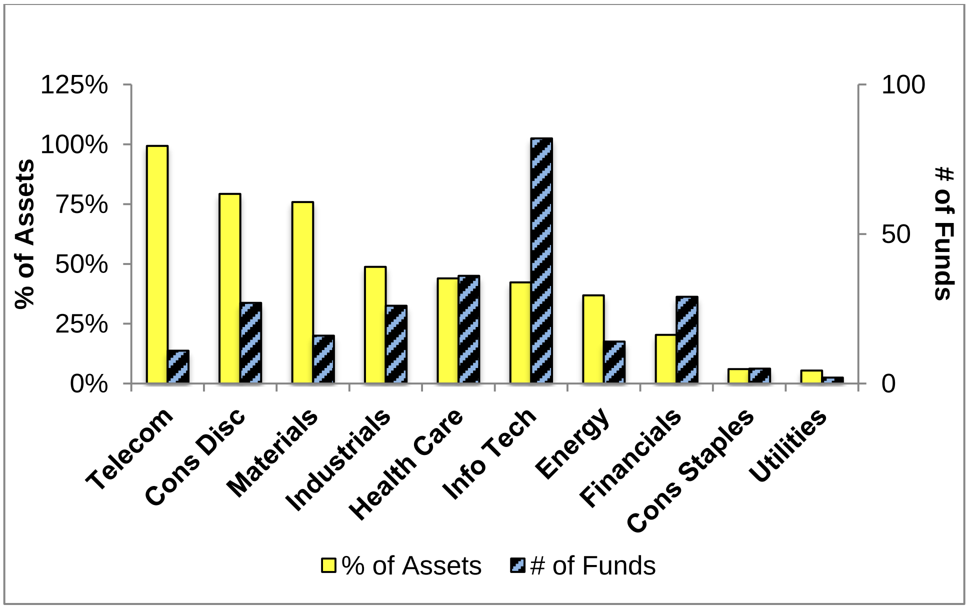
Figure 7: Attractive ETFs & Mutual Funds by Sector

Sector	% of Sector Assets	# of Attractive Funds	% of Attractive Funds in Sector
Cons Staples	11%	3	16%
Health Care	8%	9	9%
Industrials	7%	4	11%
Info Tech	5%	33	20%
Financials	2%	8	3%
Cons Disc	1%	4	11%
Telecom	0%	0	0%
Energy	0%	0	0%
Utilities	0%	0	0%
Materials	0%	0	0%

Source: New Constructs, LLC and company filings

Figure 8 presents a mapping of Neutral funds by sector. The chart shows the number of Neutral funds in each sector and the percentage of assets allocated to Neutral-rated funds in each sector.

Figure 8: Neutral ETFs & Mutual Funds by Sector



Source: New Constructs, LLC and company filings

Figure 9 presents the data charted in Figure 8.

Figure 9: Neutral ETFs & Mutual Funds by Sector

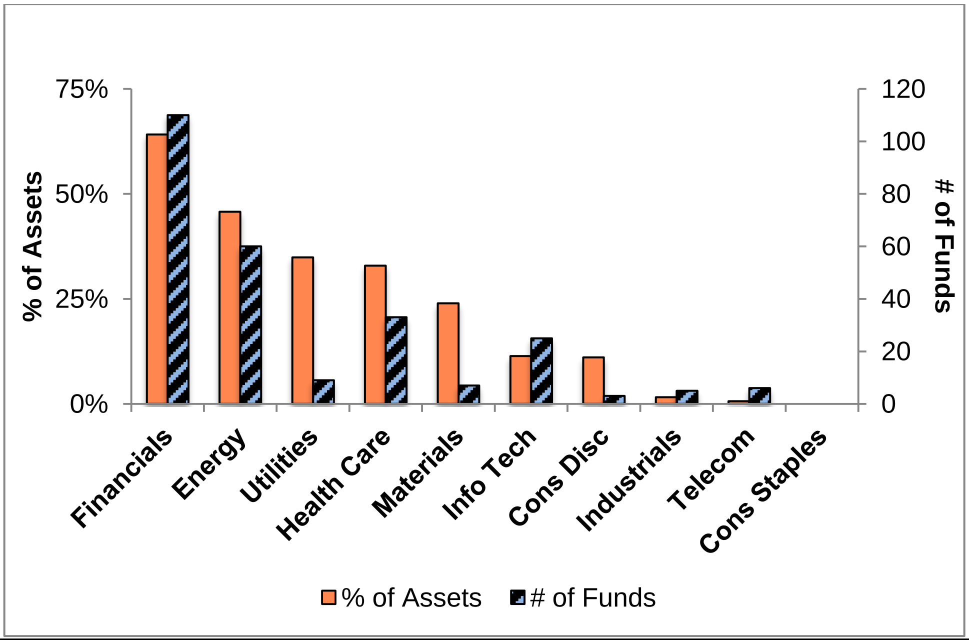
Sector	% of Sector Assets	# of Neutral Funds	% of Neutral Funds in Sector
Telecom	99%	11	58%
Cons Disc	79%	27	73%
Materials	76%	16	62%
Industrials	49%	26	72%
Health Care	44%	36	35%
Info Tech	42%	82	50%
Energy	37%	14	12%
Financials	20%	29	10%
Cons Staples	6%	5	26%
Utilities	5%	2	5%

Source: New Constructs, LLC and company filings

Figure 10 presents a mapping of Dangerous funds by fund sector. The chart shows the number of Dangerous funds in each sector and the percentage of assets allocated to Dangerous-rated funds in each sector.

The landscape of sector ETFs and mutual funds is littered with Dangerous funds. Investors in Financials funds have put over 64% of their assets in Dangerous-rated funds.

Figure 10: Dangerous ETFs & Mutual Funds by Sector



Source: New Constructs, LLC and company filings

Figure 11 presents the data charted in Figure 10.

Figure 11: Dangerous ETFs & Mutual Funds by Sector

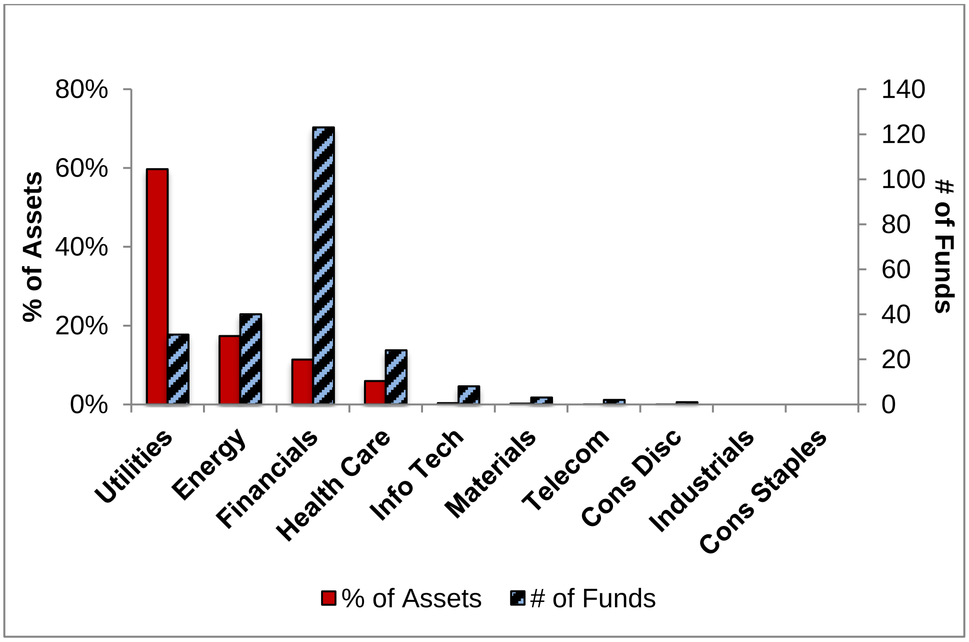
Sector	% of Sector Assets	# of Dangerous Funds	% of Dangerous Funds in Sector
Financials	64%	110	40%
Energy	46%	60	53%
Utilities	35%	9	21%
Health Care	33%	33	32%
Materials	24%	7	27%
Info Tech	11%	25	15%
Cons Disc	11%	3	8%
Industrials	2%	5	14%
Telecom	1%	6	32%
Cons Staples	0%	0	0%

Source: New Constructs, LLC and company filings

Figure 12 presents a mapping of Very Dangerous funds by fund sector. The chart shows the number of Very Dangerous funds in each sector and the percentage of assets in each sector allocated to funds that are rated Very Dangerous.

Take note of the Utilities sector, in which over 70% of funds receive a Very Dangerous rating. Investors must tread carefully when looking to invest in this sector.

Figure 12: Very Dangerous ETFs & Mutual Funds by Sector



Source: New Constructs, LLC and company filings

Figure 13 presents the data charted in Figure 12.

Figure 13: Very Dangerous ETFs & Mutual Funds by Sector

Sector	% of Sector Assets	# of Very Dangerous Funds	% of Very Dangerous Funds in Sector
Utilities	60%	31	74%
Energy	17%	40	35%
Financials	11%	123	44%
Health Care	6%	24	23%
Info Tech	0%	8	5%
Materials	0%	3	12%
Telecom	0%	2	11%
Cons Disc	0%	1	3%
Industrials	0%	0	0%
Cons Staples	0%	0	0%

Source: New Constructs, LLC and company filings

Kyle Guske II contributed to this report
Disclosure: David Trainer is long WMT. David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector or theme.

Appendix: Predictive Fund Rating System

New Constructs' Predictive fund Ratings enable smarter investing by assessing the key drivers of future fund performance. We start by analyzing every funds' holdings based on New Constructs' stock ratings, which are regularly featured as among the best by Barron's. Next, we measure and rank the all-in fund expenses. Finally, we rank the fund compared to all other funds to identify the best and worst funds in the market.

Intuitively, there are two drivers for future fund performance.

1. Stock-picking (Portfolio Management Rating) and
2. Fund expenses (Total Annual Costs Rating)

Our Predictive Fund Rating is based on these drivers and the fund's ranking:

1. Top 10% = Very Attractive Rating
2. Next 20% = Attractive Rating
3. Next 40% = Neutral Rating
4. Next 20% = Dangerous Rating
5. Bottom 10% = Very Dangerous Rating

The figure below details the criteria that drive our Predictive Rating system for funds. The two drivers of our predictive ratings system are Portfolio Management and Total Annual Costs. The Portfolio Management ratings (detail here) is the same as our Stock Rating (detail here) except that we incorporate Asset Allocation (details here). The Total Annual Costs Ratings (details here) captures the all-in costs of being in a fund over a 3-year holding period, the average period for all mutual funds.

Predictive Rating	Portfolio Management Rating						Total Annual Costs
	Business Strength		Valuation			Cash Allocation	
	Quality of Earnings	Return on Invested Capital	FCF Yield	Price to Economic Book Value	Market-Implied Duration of Growth		
Very Dangerous	Misleading Trend	Bottom Quintile	< -5%	>3.5 or -1<0	> 50	> 20%	> 4 %
Dangerous	False Positive	4th Quintile	-5% < -1%	2.4<3.5 or <-1	20 < 50	8% < 20%	2% < 4%
Neutral	Neutral EE	3rd Quintile	-1% < 3%	1.6 < 2.4	10 < 20	2.5% < 8%	1% < 2%
Attractive	Positive EE	2nd Quintile	3% < 10%	1.1 < 1.6	3 < 10	1% < 2.5%	0.5% < 1%
Very Attractive	Rising EE	Top Quintile	> 10%	0 < 1.1	0 < 3	<1%	< 0.5%

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5. **Objectivity** – New Constructs is an independent research firm, not tied to Wall Street or investment banking services. Our models are driven by comprehensive high-quality data not stories. See our presentation to the Senate Banking Committee, the SEC and many others in DC.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

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